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ABSTRACT

The four articles in this journal issue examine the pros and cons of the proposition that credit card rates are too high. In "How Congress and Consumers Will Crack the Credit Card Market," Congressman Charles E. Schumer argues that banks can get away with their excessive rates because of consumer misinformation and the unfair competitive edge held by the larger banks that set the tone for the high rates. He therefore recommends the passage of legislation that would require credit card companies to make a full disclosure of their charges before the consumer obtains a card (rather than after as is currently allowed). In "Bank Credit Cards: An Important Financial Option," Jerry D. Craft makes the case that bank card rates are service rates rather than interest rates and that credit cards have high administrative costs, are affected by fraud, and are actually one of the most competitive products in the United States. Elgie Holstein, in an article entitled "Bank Credit Cards: Defying Economic Gravity," contends that although bank credit cards are the single most profitable area of banking today, credit card price controls would hurt consumers. Holstein suggests a "floating" ceiling on credit card interest rates as a compromise. In "Retail Credit Card Rates: Reality vs. Rhetoric," Tracy Mullin distinguishes between retail and bank credit card plans, argues that revenues from retail credit cards are reasonable, and reaffirms Holstein's view that interest rate caps would not help consumers. (MN)

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ARE CREDIT CARD RATES TOO HIGH?

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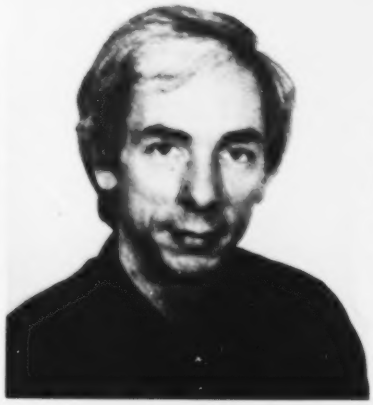
PRO:

Congressman Schumer



Elgie Holstein

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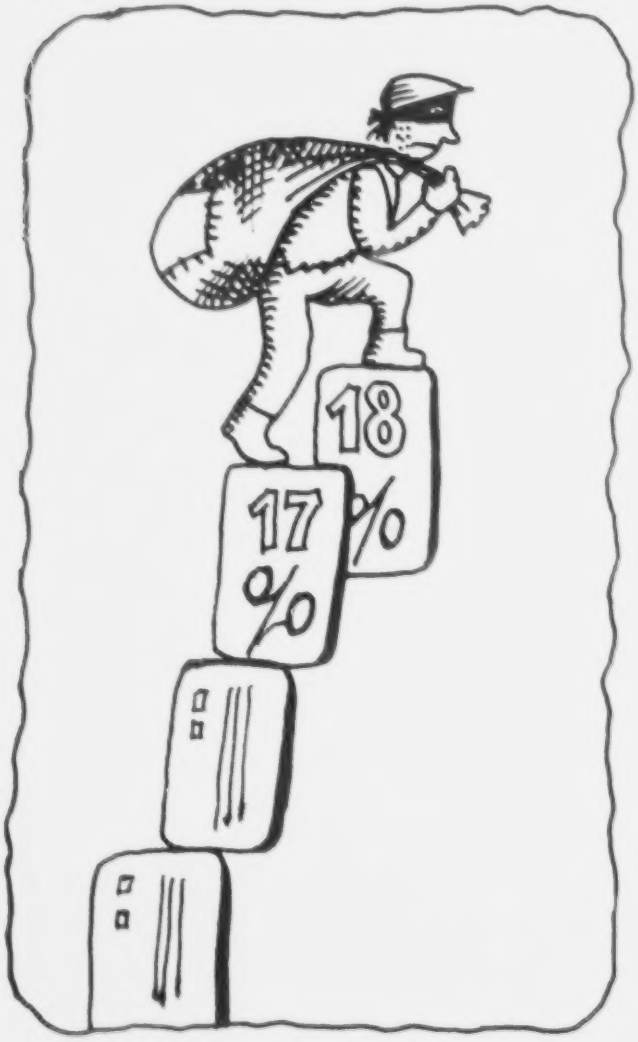
How Congress And Consumers Will Crack The Credit Card Market

Congressman Charles E. Schumer,
Member, House Banking Committee

Are Credit Card Rates Too High? Well, Do Banks Like An Easy Profit?

The credit card interest debate has raged now for over a year, but the numbers still speak for themselves. Between 1980 and 1986, the discount rate dropped from 13% to 5.5%, the prime rate dropped from 18.5% to 7.5%, auto loans dropped from 17% to 11%, 24-month personal loans dropped from 16.3% to 14.7%. . . .



And credit card interest rates *climbed* from about 17% to over 18%.

Around the country this disparity is increasingly being recognized for what it is: a rip-off. New Jersey's Republican Governor Tom Kean, in his January State of the State Message, termed credit card rates *"inexcusably high"* and said that if New Jersey banks would not lower their rates, the state legislature might do it for them. The same month, in Illinois, State Treasurer Jerome Cosentino withdrew almost $220 million in state deposits from the First National Bank of Chicago to protest its 19.8% rate.

The banking lobby, meanwhile, still holds by its old argument: credit card interest rates — 18.15% on average and up to 2 points higher at the large banks dominating the debate — are just barely high enough to cover costs. At 19.8%, the claim goes, Citibank's credit card division is barely making a go.

Perhaps the banking lobby, spread thin now as it battles credit card legislation not only in Washington but in many state governments, has been too busy to notice that its case has been contradicted by, of all things, some banks. A growing number of financial institutions have voluntarily lowered their credit card rates in recent months, some to below 11%. These banks, it should be noted, are typically among the nation's small banks, meaning their cost per card is higher — or, alternatively, their profit margin is tighter — than that of large national banks like Citibank or First National Bank of Chicago, which charge 19.8% on their regular Visa or MasterCard.

Perhaps the banking lobby has been so busy that it has not even noticed its own profit figures. According to an independent analysis, 1986 was the credit card industry's most profitable year ever. Pretax profits were about $5 billion, up by almost 40% from the year before.

Not bad for an industry just squeaking by.

Why Are Rates So High?

To paraphrase the old joke, banks are charging insanely high interest rates on their credit cards because they can.

American consumers are woefully ill-informed about the details of credit cards — in large part due to failure of credit card issuers to inform the public, though consumers must share part of the blame. Many consumers believe, falsely, that all credit card interest rates are the same, or that Visa sets the rate on its cards, or that MasterCards are only available from large national banks, or that a credit card from Ohio's Gem Bank will be accepted less widely than a card from Chicago's First National.

In fact, acording to a national survey, most credit customers don't even know the interest rate on their own card.

Credit card issuers see they can get away with usurious interest rates, and no law prohibits them from doing so.

Misinformation about credit cards can be traced to two main sources. First, the financial world's recent deregulatory revolution has given financial institutions a major advantage over typical consumers. Consider: from the Depression through the end of the Carter years, banks were essentially the same. Consumers didn't treat savings accounts or credit cards like loaves of bread because they didn't have to. Comparison shopping, which wasn't necessary when interest rates were defined by government, is now only slowly entering the financial consumer vocabulary.

Second, the large national banks setting the high-rate tone of the market have a significant competitive advantage over the handful of smaller banks with lower rates. Only large banks can afford to advertise nationally or bombard homes with direct mail ads and pre-approved applications. Consumers shopping for credit cards have heard of Citibank but not of

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Bank Credit Cards: An Important Financial Option

Jerry D. Craft, *Chairman, Retail Electronic Services and Bank Card Division, American Bankers Association, and Senior Vice President, First National Bank of America*

Like Other Valued Financial Services, Bank Cards Offer Many Benefits For A Fair Price

In today's convenience-oriented society, bank credit cards have become an important financial option for millions of Americans. A recent study by New World Decisions of New Jersey shows that almost eight in ten Americans consider credit cards more as a convenience than as a loan. Underscoring this consumer attitude is an array of benefits that come with a bank card, particularly the tremendous benefit of getting, in effect, a free 30-day loan! One-third to one-half of all bank card users pay their balances in full and avoid paying any interest charges.

Bank Cards Are A Popular Full Service Financial Tool

In addition to the built-in "*float*" feature of bank cards, there are many other advantages. Bank cards are a safe substitute for cash accepted at outlets world-wide; a reusable, lifetime line of credit; a means of identification for check cashing, car rental, hotel or other purposes; an automatic monthly record-keeping system; and a 24-hour access mechanism to automated teller machines (ATMS).

People would be hard pressed to find a better full service financial tool that could match the convenience and flexibility of bank cards. The fact that more than 70 million Americans hold 130 million bank cards is evidence of their enormous value and popularity.

Credit Cards Are One Of The Most Competitive Products In The U.S.

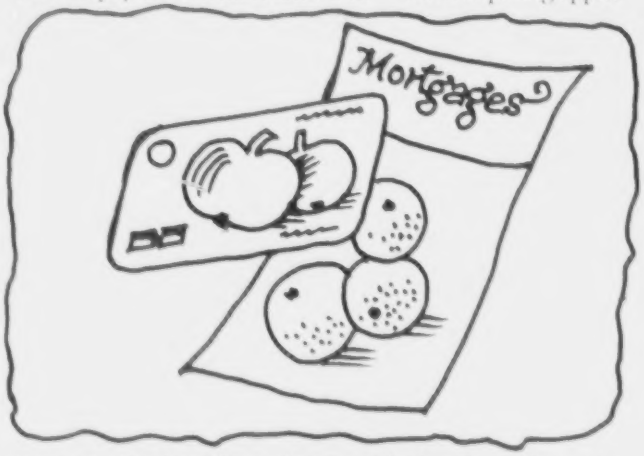
With credit card rates ranging from 10% to 22% and more than 15,000 banks, retailers or other financial institutions offering them to the public, credit cards are one of the most competitive products in the country. Today there is more evidence of competition than ever before. Some of the biggest banks in the country, including CitiCorp and Chemical Bank, have recently lowered their bank card rates. Many other banks now offer flexible card pricing in the form of tiered or variable rates.

Despite widespread competition, some people are still critical of bank card prices or practices. At the request of the editors, I will take this opportunity to explain why this criticism is unfounded.

Bank Card Rates Are Service Rates, Not Interest Rates

First and foremost, bank cards, those issued by VISA or MasterCard, are an optional, not mandatory, financial tool. Consumers actually use cash and checks more often than they use credit cards. Those who opt for card use are generally aware that the average bank card rate has remained stable over the last two decades, hovering in the 17% to 18% range, even though other types of interest rates have widely fluctuated. *This is because a credit card rate is more accurately described as a service rate rather than as an actual interest rate.* The rate charged for bank credit cards reflects the higher costs asssociated with providing a convenient, multi-use worldwide payment service.

Some people think that because mortgage rates and car loan rates have dropped, credit card rates should also drop. This is a popular but inaccurate idea — like comparing apples



to oranges. Bank credit card rates are higher than other types of consumer loans due to very high administrative costs and the equally high risk associated with an unsecured loan. Unlike a mortgage which is secured by a person's home, or an auto loan which is secured by a person's car, credit card loans are not secured by an asset and thus pose larger risks to banks.

Credit card loans are two to three times more expensive to administer than regular installment loans. The average bank card transaction is only $50.00. Multiply that small loan amount by millions of transactions — the average card customer uses a card 30 times a year — many employees, complex national and international computer hook-ups and monthly billing requirements, and it becomes obvious that the credit card service is a very expensive service to operate.

In fact, administrative costs can account for more than half of the rate charged on bank credit cards. By comparison, only a little more than 10% of the average mortgage rate can be attributed to administrative costs.

High Administrative Costs And Fraud Impact Card Operations

Some consumer advocates claim that card rates in the 17% to 18% range allow banks a large profit spread. They say that because cost of funds or interest rates have dropped, card rates should follow. This is also inaccurate because the cost of funds is just one of several major costs that have an impact on credit card operations.

Consider the costs that go into the average bank card rate of 17% to 18%: 7% can be attributed to the cost of funds; up to 5% to administrative costs including fraud, (fraud alone cost banks more than $200 million last year); 3% to the bank cost of "*float*" (the banking industry incurs an average of $10.7 billion a day in float on its credit cards) and up to 3% to credit losses. Add these together and you come up with an 18% or higher rate just to meet basic costs. In fact, usually it is the fees

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Bank Credit Cards: Defying Economic Gravity

Elgie Holstein, *Director,*
Bankcard Holders of America

Credit cards are the single most profitable area of banking today. This fact surprises many consumers who are unaware of the scale of the credit card business — or the interest rates banks charge on their cards. With the national average for credit card interest rates at 18.4%, pressure is mounting nationwide for a cap on such charges, in order to give consumers a *"fair deal"*.

Today, credit cards are no longer a luxury for the rich, but are a necessity for the millions of consumers who have grown to depend on them as an alternative payment mechanism. Consumers use credit cards to purchase clothing, pay for meals, reserve hotel rooms, purchase theatre tickets and pay for emergency car maintenance. Recent statistics show that 70% of all consumers have at least one credit card, with over 186 million cards in circulation nationwide.

Bank Profits High From Credit Cards

Yet despite the size of the credit card market, credit card interest rates have defied the laws of economic gravity. In the last six years, the interest rate for every other type of loan has fallen dramatically. For example, in 1981 the prime rate rose above 20%; today it stands at 7.75%. Home mortgage rates hit 17% in 1981; today they average about 10%. What has happened to credit card rates over the same period of time? They have actually *risen*, from an average of 17.8% in 1981 to nearly 18.5% today. With the banks paying approximately 6% for the money they lend out to credit card holders for over 18%, it's easy to see why the banks are resisting lower credit card rates: astronomical profits.

Interest rates are just one way the banks make money on credit cards, however. Consumers pay annual fees of $15 to $25 for a standard card, and the merchant pays to the card issuer a percentage of the purchase price every time the consumer uses the card. Increasingly, there are also late fees, over-the-limit fees, transaction charges and shortened or eliminated interest-free *"grace periods"* on new purchases.

How can the banks continue to get away with this highway robbery? Unlike other types of lending, the banks compete for credit card customers not on the basis of interest rates and fees, but rather by offering prestige, book-of-the-month club memberships, travel insurance, rebates, credit card registration and other so-called card *"enhancements"*. Most credit card advertising — including the mass marketed, *"pre-approved"* card offers millions of Americans receive weekly in their mailboxes — hides in tiny print the true costs of the cards. Often this vital information is not mentioned at all, making it impossible for the average consumer to shop around for the best card deal.

Some Banks Have Dropped Rates

There *are* banks currently making profits at interest rates far below the national average of 18.4%. In Connecticut, which imposed a 15% legal ceiling on credit card interest rates last year, a *"rate war"* broke out among the banks before the Governor even signed the bill. Moreover, none of the gloom-and-doom predictions of the banking lobbyists in Connecticut has come true. Credit has not dried up, banks have not moved out of the state and banks are certainly *not* losing money.

Although there are examples of banks charging lower rates, most of the good deals are available from smaller local banks that do not advertise widely. If small banks in Connecticut and elsewhere can charge fair rates, why don't the large money center banks even come close? The large card issuers dominate the market with their multi-billion dollar credit card portfolios and have refused for six consecutive years to lower their rates, even as other interest rates have fallen. They continue to mass market cards throughout the country, and although they have the lowest processing costs, (experts agree that the large card operations enjoy lower per-unit administrative costs), they charge the most and disclose the least information in their advertising.

A few states — Connecticut, Arkansas, Texas, and Washington State — have enacted laws to limit the rates banks may charge for their credit cards. Others have enacted requirements for full and prominent disclosure of all interest rates and fees in credit card advertising.

Alternatives

One compromise approach would be to impose a *"floating"* ceiling on credit card interest rates. Tied to some other index

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Retail Credit Card Rates: Reality vs. Rhetoric

Tracy Mullin, *Senior Vice President, Government Affairs, National Retail Merchants Association*

Recently some concern has been expressed that credit card rates are "*too high*" and that legislative action should be taken to lower them. Retailers disagree. Advocates of rate caps overlook a number of important points about the cost of credit extended by retailers, as well as about the revenue generated by retailers' credit plans.

The retail industry throughout the nation is highly competitive in terms of the goods and services it offers, including offering credit plans which are attractive to consumers. Recent rate reductions prove that there is competition in the credit marketplace and support our view that legislation is unnecessary. Federal law should continue to rely upon competition to ensure fair rates, while assuring that the manner in which competing credit card plans operate can be understood and compared. Each state's laws contain extensive provisions regulating credit card accounts, which (1) limit the ways and circumstances in which merchants may assess finance and other charges; (2) ensure that consumers are treated fairly and (3) in combination with federal law, ensure that consumers are able to make an informed choice among their various credit options. There is no need for Congress to intervene and set a national price for credit.

Revenues From Retail Credit Cards Are Reasonable

Proponents of restrictive rate ceilings argue that credit card issuers are reaping excessive profits. To the contrary. It can be documented that revenues from retailers' credit card plans are reasonable in relation to the costs of operating the plans.

Retailers' finance charge rates cannot properly be evaluated by focusing on the prime rate or other short-term cost of funds. Retailers do not borrow at the prime rate. Their borrowing is a mix of long-term and short-term debt. Moreover, the cost of funds typically represents 50% or less of the cost of operating a retail credit card program. The remaining costs consist of administrative expenses such as wages, postage, equipment, etc., which continue to increase, and losses due to bad debt. It is also important to remember that retailers' *effective* rates are well below the *nominal Annual Percentage Rate* that is disclosed. This is because a substantial portion of retail customers pay their bill in full each month, resulting in no finance charge revenue on such accounts.

A recent study prepared by Touche Ross & Co. confirms the results of numerous previous studies that competition has kept retailers' credit card rates in line with costs. The data from these studies documents that retailers continue to extend credit as a marketing tool, but that competitive pressures do not permit most retailers to generate enough finance charge revenue to cover the full cost of providing this service.

Credit Rate Caps Are Not Beneficial To Consumers

Proponents of restrictive rate ceilings argue that consumers will be benefitted by reducing their expenses and helping manage their debt. On the contrary, rate ceilings do not benefit consumers because they restrict the availability of credit and may result in cash customers having to subsidize credit used by others.

Historically, retail creditors have made credit available to a wide segment of the consumer spectrum. For many, particularly the young, the elderly and those on low or fixed incomes, the retail credit card is the only means at their disposal to make discretionary purchases, as well as to buy goods and services that are essential to maintain an adequate standard of living. Rate restrictions would force retailers to limit their accounts to only the most creditworthy consumers, thus denying many of the people who need and want it most the opportunity to qualify for retail credit.

Rate restrictions would also increase and misallocate costs in other ways. Some retailers might eliminate the benefit of a grace period that many consumers have come to expect. Restricting finance charge revenue also could force retailers to recoup their losses by raising cash prices. In that way, customers who pay in cash would subsidize the cost of providing credit services not used by them. Increases in merchandise prices would not be limited to retailers who offer their own credit plan. Rate restrictions could lead banks to increase the merchant discount and thus put upward pressure on retail prices.

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Simmons Bank, and they falsely figure that by sticking with the big name they are avoiding some risk.

How Consumers And Congress Will Crack The Credit Card Market

If the diagnosis is credit card fiction, the cure is easy enough to prescribe: credit card facts. Give American consumers all the important credit card information — before they sign up for a card — and they can compare and save; they can do what they must to make the market work.

Would that work? The lesson of the past year is that it would. Isolated pockets of competition have developed when the media, for local reasons, paid a great deal of attention to the bankcard case. In Connecticut, for example, local newspapers and television stations closely covered the debate in the state legislature over a proposed cap on credit card interest rates. The cap eventually became law, but because consumers had become sensitive to variations in interest rates, the debate set off a price war with many Connecticut banks dropping their rates below the 15% ceiling, some as far down as 11%.

House Resolution 515, "*The Full Credit Card Cost Disclosure Act*," which I introduced in January, would give consumers across the country the information they need — early enough to use it. It requires that card applications and pre-approved mail offers include a small table with the interest rate, annual fee, grace period and any regular charges for using the card. Current law requires disclosure, but not until *after* the consumer receives a card.

It's a free market approach, based on the premise that the credit card market can respond to consumer desires once consumers are armed with basic information. The bill passsed the House last year, and although the Republican Senate ignored it, with this year's Democratic majority, disclosure legislation becomes an odds-on favorite for passage. And consumers will bring fairness to the credit card market.

Craft *continued* from page 3

charged that make the card a viable or worthwhile product for banks. My point is that the bank card is hardly the money-maker some claim it to be.

Bank cards have historically been less profitable than other types of consumer loans. A study done by the Federal Reserve shows that the net average profit of bank cards from 1972 through 1984 was only 1.68% of balance outstanding before taxes, compared to mortgages at 2.24%; auto and other installment loans at 2.32%; and commercial loans at 2.91%.

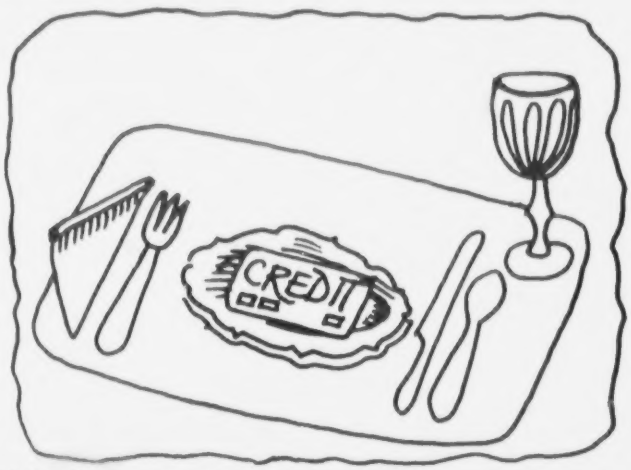
Credit Card Price Controls Would Hurt Consumers

Some people have unsuccessfully advocated credit card cap legislation. Of the 22 states that considered credit cap legislation in 1986, only two passed laws. Both state and federal legislators have recognized that such price controls are unnecessary in a competitive market that bears 15,000 credit card issuers. These people also reasoned that government-imposed caps were needed because banks hold a monopoly on the market. This is not accurate. The largest issuer of credit cards is a retailer — Sears — *not* a bank.

Those who claim credit card caps would help consumers have been proven wrong by history. Studies and experience have shown that when banks are told how to price their bank card products, the cost of administrating the programs are not met. Banks abandon the business due to the burdens imposed, and credit dries up. In Arkansas, which has one of the lowest government-imposed credit card caps, only three of the more than 260 banks still have a credit card program — and one of those three has petitioned to take its credit card program out of state. Separate studies done by the the Federal Reserve and Lexecon, Inc., an economics consulting firm, found that credit card caps would have a negative impact on consumers because banks would be forced to increase annual fees, reduce or eliminate grace periods and restrict credit in order to compensate for artificial price controls.

In addition to card rate issues, some people say banks don't provide the public with information on bank cards until after they use them. This is simply not the case. The Consumer Credit Protection Act of 1969 mandates the disclosure of information at the time any credit is made available. The American Bankers Association (ABA) has always been committed to meaningful disclosure. In fact, the association waged a nationwide voluntary effort campaign to its 13,000 member banks in 1985, encouraging them to adhere to effective disclosure policies. If additional disclosure legislation is proposed in 1987, the ABA will take efforts to ensure that all financial institutions, not just banks, are affected, so consumers will have the most equitable foundation on which to base their credit card decision.

In summary, as with any financial service, a bank card offers a variety of benefits for a reasonable price. People who decide to use bank cards should realize that credit is a privilege, not an automatic right. As with any privilege, or valued service — whether legal advice or a meal in a fine restaurant — it will be priced fairly, according to market demand, or it won't survive.



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of rates in the economy, such as Treasury bills, the ceiling would ensure that credit card rates moved up and down with

the free credit market. When the banks' costs of funds go up, they would be able to raise rates. When those costs drop, as they have for the last several years, consumers would benefit from lower charges. Unfortunately, the banks continue to reject this *"fair deal"* compromise. In fact, in some states, they are fighting to have *all* limits removed on how much they can charge.

Fed up with six years of the credit card rip-off, consumers are calling for state and federal caps on credit card interest rates. They are also demanding new requirements for fair advertising so they can begin to compare competing card offers on the basis of financial terms, not travel and entertainment benefits. Such legislation would save consumers several billion dollars per year in excess card charges and would re-ignite the competitive spirit the card issuers now seem to lack.

Since the banks have made clear that they will not be responsive to changes in the economy on a voluntary basis, legislation seems to be the only alternative for protecting consumers from unreasonably high interest rates on credit cards. While legislation is no one's first choice as the best way to bring down high credit card interest rates, without a legislative mandate banks will continue to hold up consumers with outrageously high interest rates.

In the meantime, consumers faced with high credit card costs should *"fight back"* by: switching to lower-rate credit cards; refinancing their existing high credit card debt (for example, by using a low-rate credit card *"cash advance"* to pay off high-rate balances) and letting their elected officials know how they feel about credit card issues. As in all areas of consumer protection, fair credit card charges will only come about if individual citizens fight to protect their right to a *"fair deal"*.

Mullin *continued* from page 5

Retail Credit Card Plans Differ From Bank Plans

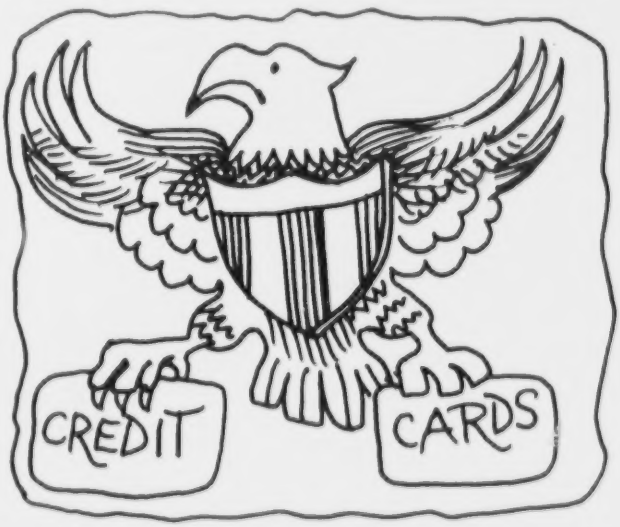
Proponents of restrictive rate ceilings argue that some banks have lowered credit rates, but retailers have been unresponsive. In fact, retailers' card plans are distinguishable from bank card plans.

There are fundamental differences in costs and revenues under bank card plans as compared with retail plans. On the cost side, bank card accounts generally involve much larger balances than do retail accounts (the typical retail account averages between $185-$285, while bank card accounts generally are in the $800 range). Thus, assuming that account processing costs are about the same in both cases, in relation to outstanding balances, the costs will be lower for banks than for retailers. Moreover, banks tend to borrow at more favorable rates than do retailers.

There are significant differences on the revenue side as well. Unlike retailers, which typically obtain all of their credit card revenue from finance charges (total annual revenue of about $25-$30 per retail account is typical), most banks levy an annual fee for issuing the card. In addition, banks obtain revenue from the merchant discount, which ranges from 2% to 6% of each sale. This comparison should not be interpreted as criticism of bank cards. All creditors must find means to generate revenues to cover the costs which are appropriate to their respective operations. Competition among credit grantors, in a credit marketplace requiring fair practices and full disclosure, will maximize consumer benefits and avoid economic distortions.

All things considered, therefore, the retailers' credit card plan is an excellent value which operates best for consumers when it is not subjected to artificial government restraint. Lowering rate ceilings may sound attractive, and represent a politically appealing issue to some legislators, but it is unsound policy.

Credit is a service, like any other, and the merchant should be permitted to price that service so that it will be available to those who want it, and so that it will be paid for only by those who use it.



Tear Off Coupon — At Home With Consumers

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The Foundation runs consumer and academic programs; provides technical support to consumer organizations; supports speakers, research and case studies for university marketing professors; distributes consumer information literature in English and Spanish; and maintains a library in Washington.

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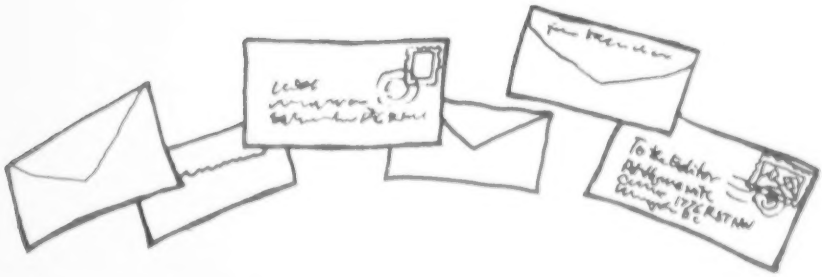

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Comments from readers are welcome. Please write Marlene W. Futterman, Executive Director, Direct Selling Education Foundation, 1776 K Street, N.W., Washington, D.C. 20006. Letters will be answered as time permits.